

**LEGISLATIVE SERVICES AGENCY  
OFFICE OF FISCAL AND MANAGEMENT ANALYSIS**

301 State House  
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**FISCAL IMPACT STATEMENT**

**LS 7666**

**BILL NUMBER:** HB 1865

**NOTE PREPARED:** Jan 27, 2003

**BILL AMENDED:**

**SUBJECT:** Inheritance Tax Exemption for Business Assets.

**FIRST AUTHOR:** Rep. Murphy

**FIRST SPONSOR:**

**BILL STATUS:** As Introduced

**FUNDS AFFECTED:** X

X

**GENERAL  
DEDICATED  
FEDERAL**

**IMPACT:** State & Local

**Summary of Legislation:** The bill exempts real and personal property used by a decedent in a trade or business from the Inheritance Tax.

**Effective Date:** July 1, 2003.

**Summary of Net State Impact:** Under the bill, the state will experience a reduction in Inheritance Tax revenue beginning in FY 2005. There could be a minimal compensating increase in Estate Tax revenue in FY 2005 and possibly FY 2006. In addition, the bill is expected to increase state General Fund expenditures for county Inheritance Tax replacement. The *minimum* net impact of the bill to the state could potentially vary from a low range of \$504,000 to \$543,000, to a high range of \$936,000 to \$1.01 M annually. This represents a minimum impact of the bill, as the federal Estate Tax data utilized to derive these estimates does not include all transfers of family-owned businesses and farms that would be exempt under this bill. In addition, the estimated ranges depend upon the distribution of business and farm transfers among the different classifications of estate beneficiaries having varying effective Inheritance Tax rates.

**Explanation of State Expenditures:** The bill could potentially increase expenditures from the state General Fund for county Inheritance Tax replacement beginning in FY 2005. The minimum estimated replacement cost could potentially vary from a low range of \$3,000 to \$6,000, to a high range of \$43,000 to \$80,000. This depends the distribution of business and farm transfers among the different beneficiary groups having varying effective Inheritance Tax rates. Also, necessary replacement funding could vary within these ranges depending upon whether, and by how much, each county's base revenue exceeds the amount guaranteed under current statute. (See *Explanation of Local Revenues*, below, for explanation of county revenue loss and replacement procedure.)

**Explanation of State Revenues:** At a minimum, exempting transfers of business and farm property from the Inheritance Tax could potentially reduce Inheritance Tax revenue by approximately \$501,000 to \$930,000

annually beginning in FY 2005. The total potential revenue loss from such an exemption, however, is indeterminable. The reduction in Inheritance Tax liabilities could lead to a temporary minimal increase in revenue from the Estate Tax. This impact would only occur through FY 2006 due to the elimination of the Indiana Estate Tax in concert with the repeal of the state death tax credit under the federal Estate Tax.

*Background:* The bill exempts from the Inheritance Tax, the value of real or personal property used by the decedent in a trade or business, including farming, that is transferred under the decedent's will, under the laws of intestate succession, or under a trust. The exemption applies to transfers from the estate of a person who dies after June 30, 2003. Thus, the revenue impact could begin in FY 2005. The Internal Revenue Service (IRS) reports that 34 federal Estate Tax returns filed by Indiana estates in 1999 (the latest year available) utilized the federal Estate Tax deduction for a *qualified family-owned business interest* (QFOBI). In addition, the IRS reports that three federal Estate Tax returns filed by Indiana estates in 1999 took advantage of the *special use valuation provisions* for family-owned farms. These federally recognized transfers of family-owned businesses and farms would qualify for the exemption proposed in the bill. However, these transfers do not include all of the family-owned businesses and farms that may be transferred annually by Indiana decedents. Under the federal QFOBI provisions, at least 50% of the aggregate value of the family-owned business must be transferred to qualified heirs. And, qualified heirs are limited to family members, and to non-family members who have been actively employed in the business for at least 10 years prior to the decedent's death. The federal provisions also include requirements for the qualified heir to materially participate in the business for at least five years after the decedent's death. The federal special use valuation provisions for family-farms require that the farm be transferred to a family member. According to the IRS report, the QFOBI deductions totaled approximately \$22.31 M in 1999 and the special use valuation deductions totaled approximately \$2.39 M in 1999. As pointed out in the discussion above, these totals only relate to family-owned businesses and farms that qualified as *family-owned* under the narrower federal Estate Tax requirements. In addition, the family-owned businesses and farms were part of estates that exceeded the federal filing requirement in 1998 (\$625,000 gross estate value) and 1999 (\$650,000 gross estate value). Thus, these totals also do not account for business and farm transfers from smaller estates.

The low range estimate assumes that business and farm transfers are made solely to lineal descendants (Class A transferees) with an effective tax rate equal to 2.23%. The high range estimate assumes that business and farm transfers are made to all three transferee groups (Class A, B, & C transferees) with an effective tax rate equal to 4.14%. These effective tax rates are estimated using the Office of Fiscal and Management Analysis (OFMA) Inheritance Tax database. The database is comprised of 112,951 records for transferees receiving property from a decedent who died between July 1, 1997, and June 30, 2000.

#### **Explanation of Local Expenditures:**

**Explanation of Local Revenues:** The bill would allow an Inheritance Tax exemption for transfers involving property used by a decedent in a trade or business, including farming. The revenue impact of this change coupled with county Inheritance Tax replacement could result in an annual net revenue loss to counties of as much as \$40,000 to \$74,000 beginning in FY 2005.

Currently, counties retain 8% of the Inheritance Tax collected on transfers made by Indiana residents. About 99.3% of Inheritance Tax revenue is derived from the resident Inheritance Tax. The estimable revenue loss from the bill ranges from to range from \$544,000 to \$1.01 M annually. Thus, the county share of this revenue loss would range from about \$43,000 to \$80,000. It is important to note that a reduction in the amount of Inheritance Tax retained by counties due to the bill may be reimbursed by the state under the replacement provision established by P.L. 254-1997. The replacement provision was established when the

Class A exemption was increased on July 1, 1997. The replacement provision guarantees that in each fiscal year each county receives an amount under the Inheritance Tax that is equal to the five-year annual average amount of Inheritance Tax revenue retained by that county from FY 1991 to FY 1997, excluding the highest and lowest year. The maximum amount of county replacement for any year is approximately \$7.5 M. Currently, most counties are retaining more revenue than is guaranteed under this replacement procedure. On average from FY 2000 to FY 2002, counties exceeded their guarantee amounts by about \$3.8 M annually, with annual shortages subject to replacement totaling about \$243,000. With base revenue to the counties totaling \$10.4 M, the revenue loss covered by replacement funds would total about \$3,000 to \$6,000. Thus, about \$40,000 to \$74,000 in base revenue exceeding the guarantee amount would not be replaced. To the extent that base revenue is less than the estimate, replacement funding would increase and the net loss due to the bill would decline. Thus, county replacement would total \$43,000 to \$80,000 only if base revenue in each county is equal to the guarantee amount.

A copy of a spreadsheet showing the amount of Inheritance Tax replacement guaranteed to each county under P.L. 254-1997 is available from the Office of Fiscal and Management Analysis.

**State Agencies Affected:** Department of State Revenue.

**Local Agencies Affected:** Counties.

**Information Sources:** *Estate Tax Returns Filed in 1999 (Nation & Indiana): Selected Items by Taxable Status*, Statistics of Income Program, U. S. Internal Revenue Service, January 2001. Barry Johnson & Jacob Mikow, Statistics of Income Program, U. S. Internal Revenue Service, (202) 874-0316 & (202) 874-0313. OFMA Inheritance Tax Database. *2003 U. S. Master Tax Guide*, CCH.

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